MASTER IN FINANCE

INDIVIDUAL REPORT

03 JANUARY 2020

STUDENT: FILIP PALINIĆ ČULIN 33964@novasbe.pt

A Work Project, presented as part of the requirements for the Award of a Master Degree in Finance from the NOVA – School of Business and Economics.

Low-Cost Carriers as disruptors to classic airline companies

FILIP PALINIĆ ČULIN - 33964

A Project carried out on the Master in Finance Program, under the supervision of:
Rosario Andre

03.01.2020.

Abstract

Research on how low cost carrier companies disrupted stable aviation and air transport sector. Making it much more competitive, easier to entry, and harder to sustain. Followed with principles how they operate, having completely different business model compared to full service carriers, such as Delta, and supported with high growth in last few years. Announcement of interesting competition, and fight for capturing consumers eager to fly.

Keywords (up to four)

Airline

Prices

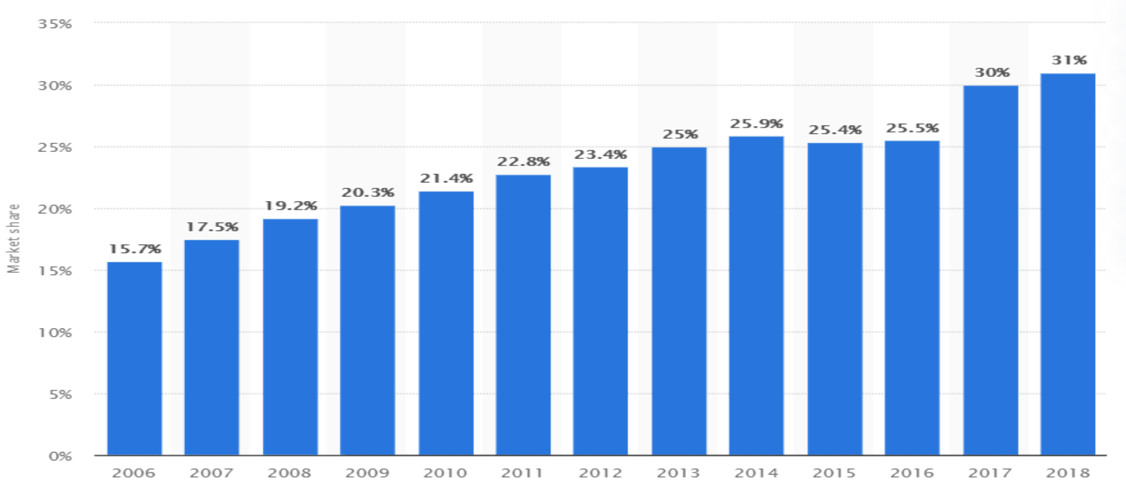
Costs

Competition

This work used infrastructure and resources funded by Fundação para a Ciência e a Tecnologia (UID/ECO/00124/2013, UID/ECO/00124/2019 and Social Sciences DataLab, Project 22209), POR Lisboa (LISBOA-01-0145-FEDER-007722 and Social Sciences DataLab, Project 22209) and POR Norte (Social Sciences DataLab, Project 22209).

As years go forward, low cost carriers proportionally have bigger influence on the market. Today low cost carriers are taking 31% of the market share, which is more than double compared 15 years ago.

Figure 1: LCC Market Share



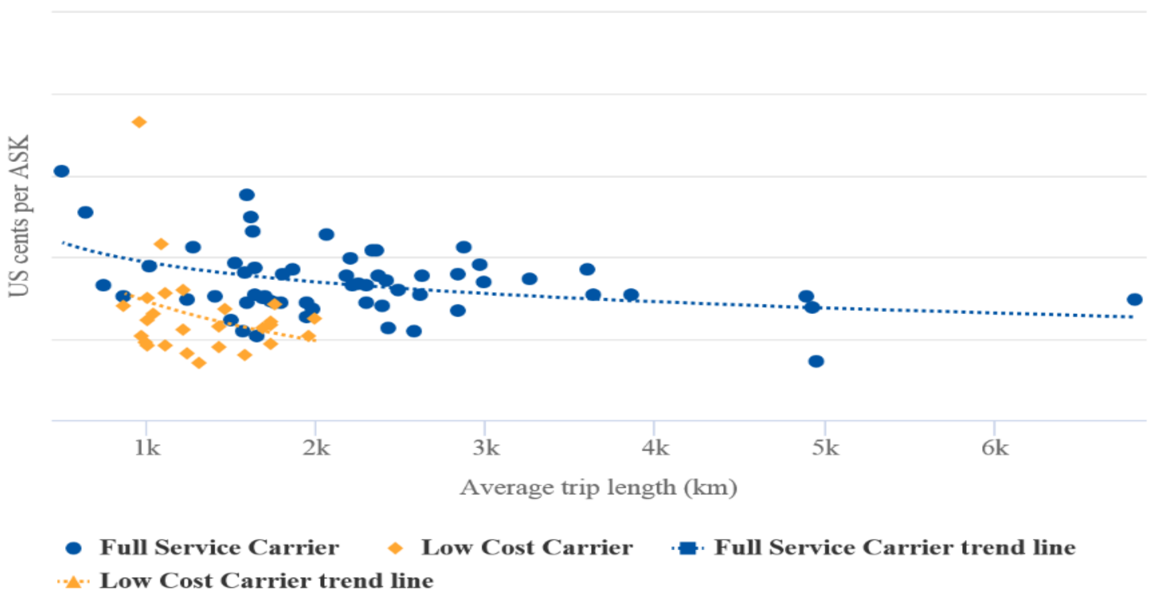
Source: Statista

They offer much lower fares compared to Delta or other classical Airline companies, which are considered to be regular type of airlines. For example, if you check fares of individual airlines, in the countries they operate, LCCs almost always record the lowest price for the day (2-3 months before the flight)[1]. They reduce costs of their operations in the amount which allows them to reduce prices charged to customers significantly and still be profitable. Even though, with such lower costs, there comes lower amenities and services offered to customers before and during flight.[2] They are reducing operating costs through lower training and maintenance costs, non-essential features in airplanes are reduced or moved entirely, they are targeting secondary airports which charge significantly lower landing fees, on those airports they are staying less time which allows them to pay less for ground time, all tickets sold and check ins are done online (if you check in physically you

1 https://www.skyscanner.net/
2 https://www.internationalairportreview.com/article/32697/low-cost-carriers/

will pay extra), and lastly you are charged for all additional baggage or requests you may have. For comparison basis, even though they are different sized companies, total operating costs for Ryan Air in 2018 were $5.483M while Delta had $34.756M of costs.[3]

Figure 2: Cost per available seat kilometre



Source: CentreForAviation

Business model LCCs developed, is based on reducing all costs, so that prices and fares charged to customers can be as lower as possible. Basically it is directed to middle class people, who couldn't afford classic airline prices and fees, and to customers who don't care how they fly as long they reach desired destination at lowest price possible. Those two types of customer groups are emerging on the market.

Services which are usually included in Delta service and offerings but not in low cost carriers, and are giving classic airlines advantage are – priority boarding, choice of seating,

[3] RyanAir and Delta Annual Report

meal and beverage services, no flight entertainment services, few or no ticket refund options. [4]

All of stated services, are something which makes your flight more comfortable, easier to handle, convenient but it is not something without passenger could not fly. Those passengers are exactly the ones who are targeted by low cost Airline companies.

How all of this is influencing Delta company value?

Well, taking the share of the company consumers, and making it more cost efficient for them to travel with LCC, is putting operating revenues of Delta at risk. With constantly increasing their market share, they are taking bigger amount of customers each year, and are capturing new ones that are entering the market. Load factor and seats flown, two unavoidable parts of revenue, together with fare revenue are in danger if this trend sustains. With lower passenger revenue, most important part of revenue drivers, NOPLAT could decrease significantly. What makes it so hard to compete with LCC is cost efficiency, or lower operating costs they have compared to Delta, which allows them to hold such low prices. Delta's option could be to adapt and to start saving on staff, salaries, maintenance etc. so it can be capable to compete with LCC in terms of price. It can also adapt low cost features apart from seats and charge them extra, in the way tickets would be cheaper if traveller don't care about amenities. Offering partnership to LCCs or having low cost subsidiary can also be an option to gain competitive advantage. There are already some examples of subsidiary strategy such as Lufthansa and Eurowings or Air-France and Transavia. It allows growth with low cost operator, and makes it easier for management to put more pressure on labour in mainline airlines to lower cost and increase productivity.[5]

In our valuation model, our perpetuity growth is 0.12% which is considerably low growth

[4] https://simpleflying.com/full-service-carriers-versus-low-cost/
[5] https://centreforaviation.com/analysis/reports/the-airline-cost-equation-strategies-for-competing-with-lccs-416644

rate, but it can’t be expected to be higher because of growing competition among LCC carriers.

Such low-cost business model in the long term, is significantly influencing value of regular Airline companies. It is decreasing revenues of classic competitors in the long run, by capturing bigger amount of customers each year and therefore decreasing passenger revenue (ticket selling revenue) of others. It increases costs of Delta and others, by making them spend more on marketing (advertising and commercials), trying to position themselves in the mind of customers as the quality ones, safer, more caring. Such marketing strategies, which are unavoidable, are costly and hard to execute in fully efficient way. Also, certain price reductions, promotions and discounts to regular ticket prices are often considered, increasing opportunity cost and decreasing real value of ticket and therefore revenue. With all aspects stated, long term NOPLAT, with existing business model and no adaptations to new market changes and players, is expected to decrease, lowering Core Free Cash Flows to the firm, which lowers equity value and share price at the end, making the value of the company lower then it is today. With increase in growth rate by only 0.5%, share price is increasing by 5%, showing importance of constantly progressing and trying to beat the competition.

Introduction of online section, through which you can do all the work regarding tickets and check ins is increasing value of the company, putting her side to side with Airline leading innovators. Opening toward international routes and networks allows Delta to interact with biggest base of customers than ever, which will be important part in capturing higher market share. Since Delta is American based company, step by step it opened its doors to international part of the world, which today takes around 30% of total sales and revenues. With hub openings, and frequent flights, Delta is putting herself in position to be present in development of other, potentially very profitable markets. Moreover, existence of Loyalty Program is very important, since it generates customer loyalty by rewarding customers with incentives to travel on Delta. Program is giving customers opportunity to earn mileage credits by flying with Delta, and all other airlines which participate in loyalty program. When traveling customers receive credits which can later be used with credit card companies, hotels, car rental agencies and others. Those credits are redeemable by customers in future periods for air travel, and allows customer to be member in Delta's Sky Club and gives access to other program awards.

All of those aspects are allowing Delta to compete with LCCs and other competitors. It is important to constantly progress and develop current business models. Even though Delta can't compete in terms of costs and prices, but in the same way, LCC cannot compete with Delta in terms of customer service and quality. As long as Delta continues to operate in that way, even though growth rate cannot be high as it was before all other players entered the market, it can constantly grow by smaller rate giving Delta the edge they need to continue to be one of the biggest Airline companies in the world.